BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of **Valencia Water Company** (U 342 W), a Corporation, for an Order Authorizing It to Increase Rates Charged for Water Service in Order to Realize Increased Annual Revenue of $3,470,000 in a Test Year Beginning July 2007 and $864,000, in an Escalation Year Beginning July 2008, and to Make Further Changes and Additions to Its Tariff for Water Service.	A.06-07-002

REPLY BRIEF OF THE DIVISION OF RATEPAYER ADVOCATES

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I. INTRODUCTION

Pursuant to Rule 13.11 of the Commission's Rules of Practice and Procedure, and the schedule set by Administrative Law Judge ("ALJ") Bemesderfer, the Division of Ratepayer Advocates ("DRA") files this Reply Brief to respond to arguments made by parties regarding the General Rate Case ("GRC") application filed by Valencia Water Company ("Valencia"). DRA's Reply Brief is directed primarily to arguments Valencia made in its Opening Brief. Most of Valencia's arguments are taken from its Rebuttal testimony, which DRA's Opening Brief already addresses. In this Reply Brief, therefore, DRA focuses primarily on arguments DRA did not previously address, or that require further discussion. Silence on any subject should not be interpreted as agreement or disagreement.

II. ESCALATION FACTORS

In its Opening Brief, Valencia disputes DRA's test year expense accounts estimates, claiming the accounts incorporated in the stipulation have not been adjusted to reflect the most recent escalation factors. (Valencia Opening Brief, p. 79.) DRA disagrees with Valencia's contention. The expense accounts in question were the subject of a stipulation between the parties.[1] However, the parties discovered at the end of hearings that a disagreement existed as to whether the expense accounts should be escalated with the most recent escalation factors. DRA understood that the stipulation incorporated these expense accounts at the amounts proposed in Valencia's application. (See Ex. V-1, table 5-2.)

In addition to its independent evaluation of the above expense accounts requests, DRA analyzed Valencia's methods of estimating the expense accounts for Test Year 2007-2008. DRA found no methodological differences between its estimates and Valencia's. After applying the June 30, 2006 escalation factors, DRA's analysis showed

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[1] The expense accounts in question are listed on pages 3-3 to 3-4 of DRA's Results of Operations Report. (See Ex. DRA-7, p. 3-3 to 3-4.)

that the amounts Valencia requested in its application for the expense accounts were reasonable. (See Ex. DRA-7, p. 3-3 to 3-4.) This approach is consistent with past DRA practice. Therefore, DRA recommends that the Commission adopt the amounts for the applicable expense accounts that were requested in Valencia's application and not an adjusted amount.

III. BASE REVENUE MEMORANDUM ACCOUNT

In its Opening Brief, Valencia urged the Commission to approve its Base Revenue Memorandum Account ("BRMA") to decouple water sales from revenue. (Valencia Opening Brief, pp. 78-79.) In addition to its opposition to the last-minute character of the BRMA request, consideration of the BRMA is untimely in view of the Commission's recently issued Order Instituting Investigation ("OII") to consider policies to achieve the Commission's conservation objectives for Class A water utilities. (See generally I.07-01-022.)

In order to promote the Water Action Plan's conservation objectives, the Commission opened an investigation on January 11, 2007 "to address policies to achieve the Commission's conservation objectives for Class A water utilities by requesting comments on increasing block rates, water revenue adjustment mechanisms, rebates and customer education, conservation memorandum accounts, and rationing programs." (See id., p. 1.) In addition, the Commission consolidated all "pending conservation rate design applications to set rates and adopt mechanisms and programs in accordance with policies adopted in this proceeding."[2] (See id.)

Since the Commission intends to establish policy on conservation issues through the OII, Valencia's request for a BRMA is untimely and should be rejected by the Commission. One of the main objectives of the OII is to evaluate "conservation memorandum accounts" like the BRMA. (See id., pp. 7-8.) The BRMA is a new concept developed by Valencia and has not been used or evaluated in a prior GRC.

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[2] The OII also indicated that "[s]ubsequent applications raising similar issues that are filed by other Class A water utilities may also be consolidated with this proceeding." (See I.07-01-022, p. 3.)

Therefore, given that the Commission has already expressed its intention to establish policy on "conservation memorandum accounts" through the OII, rather than via individual applications, the BRMA portion of Valencia's request should be disallowed. The OII indicates that once a decision is issued on the conservation policy issues, individual companies will be authorized to file appropriate advice letters to implement authorized conservation measures. (See id., p. 3.) Therefore, DRA recommends that Valencia's request for a BRMA be denied and that Valencia request a BRMA after the conclusion of the Commission's water conservation OII.

IV. WATER SOFTENING PROJECT

DRA addressed a majority of Valencia's arguments concerning the water softening demonstration project ("softening project") in its Opening Brief. However, DRA will address the issues of the support of water purveyors and government agencies for the softening project as well as Valencia's interpretation of its customers' willingness to pay for softer water.

A. The Support of Water Purveyors and Government Agencies for the Softening Project is of Limited Significance

In its Opening Brief, Valencia emphasizes that water purveyors and government agencies in the region support the softening project. (Valencia Opening Brief, pp. 43-44, 51.) Valencia refers to letters included in its rebuttal testimony supporting the softening project. (See Ex. V-36, Att. 1-3.) However, this support is of limited significance in assessing the benefit of the softening project since it is not apparent to what degree, if any, these government agencies and water purveyors have evaluated the costs and effectiveness of the softening project or the equity concerns discussed in DRA's Opening Brief. (DRA Opening Brief, pp. 23-25.) Furthermore, the fact water purveyors and government agencies support the softening project is to be anticipated since Valencia's construction of the softening project will provide them with a substantial benefit without any financial or logistical contribution on their part.

Although the letters include brief statements generally supporting the softening project, they do not indicate to what degree, if any, the water purveyors and government agencies have investigated the cost-effectiveness of the softening project. (Id.) The letters include no discussion of whether the water purveyors and government agencies have considered the financial impact of the softening project on Valencia's ratepayers or the equity concerns presented by those ratepayers solely funding a study of the new pellet softening technology.[3]

Both government agencies and independent water purveyors stand to substantially if Valencia builds the water softening project even though they will not make any financial contribution to the facility. Building the softening project presents no risk to either water purveyors or government agencies. From the perspective of water purveyors, Valencia's ratepayers will fund an evaluation of whether the new pellet softening technology is effective and economical in dealing with hard water. The softening project provides the government agencies with an opportunity to shift the responsibility and costs of determining strategies to reduce chloride levels in the Santa Clara River to Valencia's ratepayers.

If pellet softening is determined to be unsuitable or ineffective, only Valencia's customers would suffer any financial loss. Valencia claims that in the future, they will "negotiate a fair sharing of responsibility and cost among water purveyors on a region wide basis." (Valencia Opening Brief, p. 51.) However, there is no guarantee that Valencia's ratepayers will be compensated for funding the construction and operation of the softening project, especially if it proves to be ineffective.

[3] Equity concerns include: 1) The nearly 85% of Valencia customers who do not use Self-Regenerating Water Softeners will bear the costs for the problems caused by the 14% who do; 2) The Valencia customers who do not use Self-Regenerating Water Softeners will bear the costs to address an issue that faces the entire Santa Clarita Valley; and 3) A majority of Valencia customer's do not want to pay the required costs for the softening project. (DRA Opening Brief, pp. 23-25.)

B. Valencia Mischaracterizes DRA's Interpretation of the Water Quality Study Results

In its Opening Brief, Valencia claims that DRA's interpretation of Valencia's survey "as indicating that most customers are unwilling to pay more for softer water… is not well founded." (Valencia Opening Brief, p. 46.) Valencia mischaracterizes DRA's testimony, claiming that DRA interpreted the Water Quality Study to mean that a majority of Valencia customers were not willing to pay anything for softer water. (See id.) DRA disagrees with Valencia's claim. DRA argued that the Water Quality Study clearly shows that a majority of both Valencia's business and residential customers are not willing to pay either: 1) any amount of money, or 2) over $9.99/month for softer water, which is below DRA estimates of the rate impact from the water softening project.[4] (See Ex. DRA-7, p. 4-17 to 4-18.)

The Water Quality Study clearly shows that a majority of Valencia's business and residential customers are unwilling to pay either any additional amount of money or over $9.99/month for softer water.[5] (See Ex. DRA-10, p. 39.) Overall 64% of business customers are not willing to pay any additional amount for softer water. (See id.) Another 8% of business customers would be willing to pay up to $9.99/month for softer water. (See id.) 31% of residential customers are not willing to pay any additional amount for softer water. (See id.) Another 33% of residential customers would be willing to pay up to $9.99/month for softer water. (See id.) Therefore, 72% of Valencia's business customers and 64% of its residential customers are unwilling to either any additional amount of money or over $9.99/month for softer water. (See id.) These numbers clearly indicate that a majority of Valencia's customers do not place a

[4] DRA's analysis of the rate impact of the softening project shows that residential customers would wind up paying an additional $13.80 to $18.60 per month. (See Ex. DRA-7, p. 4-18; Att. A.)

[5] 43 to 47% of Valencia's customers currently soften their water. (Valencia Opening Brief, p. 46.) In evidentiary hearings, Mr. DiPrimio incorrectly asserted that "over half" of Valencia's customers installed water softening devices. (See Tr. Vol. 3, p. 219.)

high value on having softer water. Thus, Valencia's arguments to the contrary should be dismissed.

V. COST OF CAPITAL

A. Capital Structure

In its Opening Brief, Valencia argues that DRA has provided limited support for its recommended capital structure. (Valencia Opening Brief, pp. 13, 15.) DRA disagrees and has presented ample evidence of the benefits of a balanced capital structure for ratepayers as well as of the Commission's preference for a balanced capital structure for Class A water companies and other public utilities. Furthermore, the burden of proof rests on Valencia as to the reasonableness of its atypical capital structure.

Valencia contends that DRA has not supported its recommended imputed capital structure of 52.6% common equity, 46.4% debt and 1% preferred equity. (See Ex. DRA-12, p. 1-2.) As DRA discussed in its Opening Brief, Valencia's common equity ratio of 69% is considerably higher than the average of the comparable group of six water utilities used in DRA's Discounted Cash Flow and Risk Premium Model analyses as well as that of the four major Class A water companies in California. (DRA Opening Brief, pp. 38-39.)

In its Opening Brief, DRA contended that a capital structure with a high ratio of equity is burdensome to ratepayers. (Id. at 39.) As Mr. Aslam testified, a high equity ratio is burdensome to ratepayers because of equity is more expensive for customers when compared debt. (Tr., vol. 3, p. 245, Aslam/DRA.) A higher proportion of equity is also more expensive to ratepayers "because interest payments are tax deductible while returns on common equity are not." (<u>Re San Gabriel Valley Water Co.</u>, 32 CPUC 2d 423, 439, D.89-09-048.)

Furthermore, past Commission decisions support a capital structure with a balanced capital structure.

> [W]e have generally deemed a high equity capital structure, like that of Great Oaks, less than desirable for Class A water companies, as well as for other public utilities. This is because a high equity structure is generally inefficient in that it causes the public to be burdened with the higher costs

> of obtaining capital. (Re Application of Great Oaks Water Co., 51 CPUC 2d 623, 626, D.93-10-046.)

The Commission has asserted that "[a] more normalized capital structure, such as the 45% debt and 55% equity ratio generally set for Class A water utilities, is generally more desirable." (Id. at 627.)

Additionally, Valencia argues that DRA's recommended "imaginary" capital structure is problematic because it differs from Valencia's actual capital structure. (Valencia Opening Brief, p. 13.) However, DRA believes an imputed capital structure is an appropriate and feasible recommendation to mitigate the burden of Valencia's high equity ratio capital structure on its ratepayers. During Great Oaks Water Company's last general rate case, the Commission adopted an imputed capital structure with an imputed equity ratio that was drastically lower than Great Oaks Water Company's actual equity ratio. (DRA Opening Brief, pp. 40-41.) Moreover, the Commission has characterized an imputed capital structure as:

> "…. a reasonable and fair ratemaking method that protects both the ratepayers' and the shareholders' interests." (Id. citing Federal Power Commission v. Hope Natural Gas Co. (1944) 320 U.S. 591, 600; Duquesne Light Co. v. Barasch (1988) 488 U.S. 299, 314; Federal Energy Regulatory Commission v. Pennzoil Producing Co. (1979) 439 U.S. 508, 517; Wisconsin v. Federal Power Commission (1963) 373 U.S. 294, 309; Federal Power Commission v. Natural Gas Pipeline Company (1942) 315 U.S. 575, 586.)

Lastly, DRA emphasizes that the burden of proof is on Valencia. Valencia, not DRA has the ultimate burden of proof of as to the reasonableness of its atypical capital structure. As the Commission has found in other rate cases, "the burden of proof never shifts from the utility which is seeking to pass its costs of operations onto ratepayers on the basis of the reasonableness of those costs." (Application of Pacific Gas and Electric Company, 4 CPUC 3d 315, 340, D.00-02-046 citing Re Pacific Bell, 27 CPUC 2d 1, 21, D.87-12-067.) Valencia has not proved, by clear and convincing evidence, the reasonableness of a capital structure that unreasonably burdens ratepayers.

VI. CONCLUSION

For all the foregoing reasons, and for the reasons set forth in its testimony, DRA respectfully requests that the Commission adopt its recommendations.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of **REPLY BRIEF OF THE DIVISION OF RATEPAYER ADVOCATES** in **A.06-07-002** by using the following service:

[X] **E-Mail Service:** sending the entire document as an attachment to all known parties of record who provided electronic mail addresses.

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Executed on February 5, 2007 at San Francisco, California.

/s/ ALBERT HILL
Albert Hill

N O T I C E

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